Machakos University College

SCHOOL OF BUSINESS

END OF SEMESTER EXAMINATIONS-2016-----BAC204 BUSINESS FINANCE II

INSTRUCTIONS

TIME-2Hrs

ANSWER QUESTION ONE,WHICH IS COMPULSORY AND ANY OTHER TWO

QUESTION ONE (30 Marks)

a) Explain limitations of the Accounting Rate of Return (ARR) as one of the techniques in investment appraisal decisions. (5 mks).

b) Explain the factors that determine the cost of capital for an organization. (5 mks).

c) Calculate the Internal Rate of Return(IRR) of a project whose initial cost is shs. 450 million and is expected to generate cashflows amounting to shs 70 million p.a over its 10 years of useful life. The tax rate is 10% and the project has no scrap value . (5mks)

d) From the following information calculate the operating cycle: (15 mks)

	31.12. 2010	**31.12.2011**
	Shs.	Shs.
Sales	400,000	460,000
Cost of goods sold	330,000	390,000
Purchases of raw materials	220,000	270,000
Accounts receivable	50,000	57,000
Accounts payable	32,000	45,000
Raw Material inventory	56,000	98,000
Work in progress	28,000	49,000
Finished goods stock	64,000	70,000

Note: All sales and purchases are on credit.

QUESTION TWO (20 Marks)

a) Explain the various dividend policies.

b) Briefly explain six factors affecting the amount of dividend paid.

QUESTION THREE (20 Marks)

P. Muli was recently appointed to the post of investment manager of Masada Ltd. a quoted company. The company has raised Sh.8,000,000 through a rights issue.

P. Muli has the task of evaluating two mutually exclusive projects with unequal economic lives. Project X has 7 years and Project Y has 4 years of economic life. Both projects are expected to have zero salvage value. Their expected cash flows are as follows:

Project	**Year**						
	1	**2**	**3**	**4**	**5**	**6**	**7**
X Cash flows (Sh.000)	2,000	2,200	2,080	2,240	2,760	3,200	3,600
Y Cash flows (Sh.000)	4,000	3,000	4,800	800			

The amount raised would be used to finance either of the projects. The company expects to pay a dividend per share of Sh.6.50 in one year's time. The current market price per share is Sh.50. Masada Ltd. expects the future earnings to grow by 7% per annum due to the undertaking of either of the projects. Masada Ltd. has no debt capital in its capital structure.

Required:

(a) The cost of equity of the firm. (3 marks)

(b) The net present value of each project. (6 marks)

(c) The Internal Rate of return (IRR) of the projects. (Rediscount cash flows at 24% for project X and 25% for Project Y). (6 marks)

(d) Briefly comment on your results in (b) and (c) above. (2 marks)

(e) Identify and explain the circumstances under which the Net Present Value (NPV) and the Internal Rate of Return (IRR) methods could rank mutually exclusive projects in a conflicting way. (3 marks)

QUESTION FOUR (20 Marks)

a) Explain why determination of cost of capital of a firm is important ?

b) Dawamu Ltd wishes to expand its business. On 31st December 2014, the company had the following existing and proposed capital structures.

The existing 8% Debt capital has a book value of Ksh.500,000 and matures in 80 years. The market value of the debt at the close of business on 31st December 2014 was Ksh.400, 000.

A ten year loan of Ksh.3 million is to be raised at an interest of 10% p.a. A cost of KShs. 200,000 will be incurred in raising this loan.

A 12% preference stock capital stands in the books at Ksh.1 million(10,000 shares) and has a total market value of Ksh.1.5 million.

There are 400,000 ordinary shares with a current market price of Ksh.15 each. The firm's expected earnings per share(EPS) stand at ksh.2, its growth rate is 6% and has a dividend of payout of 60%.

REQUIRED:

Compute the firm's current Weighted Average Cost of Capital (WACC)

QUESTION FIVE (20 Marks)

a) (i)When rights are issued the shareholder has three options available , name them. (3mks)

(ii) Distinguish between Factoring and invoice Discounting as a source of finance.

(4mks)

b)A company has an investment opportunity costing shs.40,000 with the following expected net cash flows (i.e. after taxes and before depreciation):

Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Net cash flows(shs.000)	7	7	7	7	7	8	10	15	10	4

Using 10% as the cost of capital (rate of discount), determine the following:

i) Net present value at 10% discounting factor

ii) Profitability index at 10% discounting factor

iii) Internal Rate of Return(IRR) –Rediscount at 15% discounting factor.